example, foreign assistance could be made less concessional--that is, less reliance might be placed on outright grants or heavily subsidized loans. Moreover, as nations develop, their access to commercial capital markets should diminish the overall need for concessional assistance. Establishing a link between levels of development and the availability of aid could thus create additional opportunities for budget savings. Specific options are discussed below and summarized in Table VII-9.

TABLE VII-9. BUDGET SAVINGS FROM REDUCTIONS IN AID TO FOREIGN GOVERNMENTS AND INTERNATIONAL ORGANIZATIONS (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Increase the Share of Bilateral Aid Provided as Loans a/						
Budget Authority	4	12	21	33	46	115
Outlays	4	12	21	33	46	115
Raise Interest Rates on Bilateral Loans a/						
Budget Authority	7	23	48	81	123	282
Outlays	7	23	48	81	123	282
Decrease Paid-In Contributions to Multilateral Development Banks						
Budget Authority	31	31	31	31	97	219
Outlays	4	11	15	19	43	92

a. Savings from this pair of options are not additive.

Increase the Share of Bilateral Aid Provided as Loans and Raise Interest Rates. In recent years, an increasing proportion of U.S. assistance authorized under the Foreign Assistance Act of 1961 has been provided in the form of grants rather than loans. While 29 percent of bilateral assistance in 1980 was provided in the form of loans, by 1982 that share was only 15 percent. This trend has occurred across all forms of bilateral economic assistance and security assistance programs.

Significant savings could be achieved by increasing the share of bilateral assistance provided in the form of concessional loans rather than grants. Increasing loans to the same proportion as prevailed in 1980 could result in increased repayments--in effect savings--of $115 million through 1988. Other savings could be obtained by setting interest rates on the loans closer to those prevailing among commercial lenders. The Foreign Assistance Act fixes minimum interest rates on bilateral loans at 2 percent during program implementation and 3 percent during repayment. If the rates were set at 8 percent, repayments would increase by $282 million over the next five years.

Decrease Paid-in Contributions to Multilateral Development Banks. The United States participates in several multilateral development institutions, including various facilities of the World Bank and the Asian and Inter-American Development Banks. These institutions in turn make funds available to developing countries at concessional rates of interest. Unlike bilateral development assistance, which has focused on the basic needs of the poorest peoples in developing countries, multilateral assistance has focused on the development of infrastructure--such as road construction, energy exploration and development, and electrification.

The United States has historically provided the bulk of the financing for these organizations, contributing 25 to 30 percent of their total resources. These contributions can be separated into two components: "paid-in" and "callable" capital. Paid-in capital consists of funds authorized and appropriated by the Congress that are actually disbursed to the lending institutions. These funds are used to make loans to the poorest developing nations at well below market rates of interest. Callable capital, by contrast, is only subject to authorization by the Congress and, in fact, is never disbursed from the U.S. Treasury. Callable capital--along with similar contributions on the part of other donor countries--provide guarantees for the financial instruments that development banks issue in order to raise funds in world financial markets. The proceeds from these bond sales are then lent to middle-income countries at rates that reflect the cost of funds to the lending institution. An actual drawing by the development banks on such callable capital would occur only if the institution was unable to meet its obligations to its creditors.

Historically, about 10 percent of the funds authorized for multilateral development banks have been in the form of paid-in capital. In recent years, as more of the nations eligible for loans have attained higher levels of development (allowing for lower levels of concessionality), the ratio of paid-in capital has declined to 7.5 percent of total contributions. As the poorer countries that borrow from these institutions develop economically, this ratio could be further reduced. If paid-in capital was reduced to 5 percent of total contributions by 1988, savings through that year would amount to $92 million.

Other Government Operations

The final category of nondefense discretionary spending--"other government operations"--totaled $17 billion in 1982 and is expected to rise to $19 billion in 1983. Although these costs cover many different activities, ranging from the conduct of foreign affairs to the regulation of occupational health and safety, three areas account for about 70 percent of total expenditures--the administration of Social Security and Medicare, the administration of justice, and the collection of taxes and other general management functions.

Because the great majority of all expenditures in this category are attributable to the costs of paying federal employees, significant savings would require workforce reductions. [6] Relatively uncontrollable workload factors limit the savings opportunities, however. As the number of Social Security beneficiaries increases, for example, more resources are needed to administer that program and process claims. Similarly, as the number of income-tax filings grows, the size of the Internal Revenue Service expands. Savings opportunities are further limited by recent policy decisions to expand activities for drug enforcement, control of violent and white-collar crime, income tax compliance and simplification, and the collection of debts owed the government. Any workforce reductions that could be achieved would eventually produce annual payroll savings of approximately $250 million in 1984 dollars for each reduction of 10,000 federal employees. In the short run, however, workforce reductions could increase outlays as a result of severance payments, payments for unused leave, and retirement refunds for laid-off federal workers.

Other savings--described below and summarized in Table VII-10--could be achieved either by cutting administrative overhead or by changing the way in which legislative mandates are applied.

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6. Options for reducing outlays through changes in compensation rules and pension benefits are discussed in Chapter VIII.

TABLE VII-10. BUDGET SAVINGS FROM REDUCTIONS IN OTHER GOVERNMENT OPERATIONS (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Improve Federal Office Space Use						
Budget Authority	10	50	95	140	190	485
Outlays	10	50	95	140	190	485
Change Davis-Bacon Wage Requirement a/						
Budget Authority	95	100	105	110	115	530
Outlays	30	60	80	90	100	365

a. Some of these savings would appear in national defense budget accounts.

Improve Federal Office Space Use. The General Services Administration (GSA) acquires and manages some 146 million square feet of office space for federal agencies. About half of the GSA inventory is government-owned space and the other half is obtained through commercial leases. Since 1975, GSA has assessed agencies for the use of office space through charges that are intended to approximate rents for comparable space in the private sector.

Costs could be reduced by utilizing the existing office space inventory more efficiently. In the past, GSA targeted a 20 percent reduction in office space for executive branch employees, but has now lowered its target to about 7 percent. If a 10 percent reduction could be phased in over the next five years, savings of $485 million could be achieved through 1988, with annual savings exceeding $235 million thereafter. Such a change could, however, cramp some agency operations and might require expanding GSA's authority to assign office space. (The savings shown here reflect both reduced outlays from scaling back the leased inventory of privately owned offices and the increased offsetting receipts from leasing some of the unused government-owned space to nonfederal tenants.)

Change Davis-Bacon Wage Requirement. The 1931 Davis-Bacon Act and over 70 related federal statutes require that wages paid on most federally funded and federally assisted construction equal the prevailing wage in the local area. The prevailing wage is now determined by the Secretary of Labor to be that rate paid to a majority of workers in each job classification. If there is no majority paid at an identical rate, the rate paid to at least 30 percent of workers is used; finally, if there is no identical wage paid to at least 30 percent of all workers in a job classification, the average wage for the classification is used. In 1981, these requirements covered about two-fifths of the $237 billion in new construction put in place in the United States.

Recent evidence suggests that in some localities and for some types of construction the 30 percent rule raises federal construction costs by favoring union wage scales rather than the local prevailing rate. In January 1982, the Department of Labor issued a regulation that will eliminate the 30 percent rule, leaving the majority or average wage rules in effect. This change is expected to result in cumulative outlay savings of nearly $500 million through 1988. Additional savings could be achieved if the Congress amended the Davis-Bacon Act to define the prevailing wage as the average local wage rate--eliminating the majority rule entirely. Such a change would reduce outlays by $365 million through 1988--in addition to the savings expected to be achieved by the new regulations. This change would, however, alter the longstanding interpretation of the prevailing wage as the rate paid to most workers in an area, moving instead to a wage standard--the average--that may actually not be paid to any present workers. Moreover, this change would actually increase the wage standard for those labor markets in which the average rate exceeds the majority wage.

CONCLUDING COMMENTS

Nondefense discretionary spending is expected to total $145 billion in 1983--up only $4 billion since 1980. Over that three-year period, spending for this budget category will decline by 16 percent in real terms and decrease from 24 percent to 18 percent of all federal outlays.

Although nondefense discretionary spending has grown very little during the past three years, while shrinking in real terms and as a share of all federal outlays, the Congress might choose to reduce funding for specified appropriated domestic programs as a partial solution to looming budget deficits. Because of the fragmented nature of nondefense discretionary spending, however, appreciable overall savings could be achieved for the category as a whole only by combining cuts in numerous individual programs. Identifying opportunities for such further reductions in an area of the budget that has already been subjected to substantial funding cutbacks is the challenge facing the Congress in dealing with nondefense discretionary spending in the 1984 budget.

CHAPTER VIII. COMPENSATION FOR FEDERAL CIVILIAN WORKERS

In 1982, more than $1 of every $10 the federal government spent--a total of $77 billion, or 10.6 percent of the federal budget--went toward the pay and benefits of federal civilian workers. Of these total compensation expenditures, 91 percent went to pay 2.2 million active-service employees and to disburse pensions for 1.8 million annuitants. The remaining 9 percent covered the costs of other employee benefits--group health plans, life insurance, workers' compensation, and the like. About two-fifths of these compensation costs supported activities in the Defense and State Departments; the remainder supported domestic activities carried out by other agencies.

Costs for the various components of civil service pay and benefits affect different portions of the federal budget, and they are distributed among the accounts of the relevant agencies. To present a unified view of federal civilian personnel costs, and to illustrate various possibilities for achieving budgetary reductions in this area, this chapter combines the various aspects of compensation. The deficit reduction options examined would either change levels of pay and benefits or limit the numbers of persons receiving such payments. (Because changes in numbers of employees influence pay and benefit outlays, compensation-related budgetary savings could result from some of the program reductions considered in Chapter VII, inasmuch as those reductions could affect numbers of federal civilian personnel.)

BUDGET HISTORY AND PROJECTIONS

Since 1980, the cost of compensating federal employees has grown at an average annual rate of 9.8 percent. Recently enacted legislation that effected program cuts has moderated compensation expenditures, however, and will continue to do so in the future. Even so, total 1983 costs for federal civilian pay and benefits will exceed $82 billion--some $5.6 billion more than in the year before. The net budgetary impact is somewhat smaller, estimated at $72 billion for 1983, because of receipts and collections from off-budget agency contributions and from employee withholdings for Civil Service Retirement (CSR) and other benefit programs. (The U.S. Postal Service, an off-budget federal entity, participates in the same fringe benefit programs as on-budget agencies. Thus, this chapter includes fringe benefit expenditures for postal workers and retirees but excludes postal payroll costs.)

Recent History, 1980-1982

Expenditures for pay alone account for more than 65 percent of annual compensation costs. From 1980 through 1982, however, nearly one-half of the $13 billion cost increase occurred in federal benefit programs--$4.8 billion in federal pensions and $1.7 billion in other benefit costs (see Table VIII-1). Over 60 percent of the $6.5 billion increase in federal benefit costs resulted from post-retirement increases in CSR annuities automatically linked (that is, indexed) to changes in the Consumer Price Index. Higher health-care premiums and more numerous CSR beneficiaries caused most of the remaining growth.

The rapid rise in federal compensation costs was tempered by limits on annual pay increases, which held federal salaries below private-sector levels. To a lesser extent, cost growth was also moderated by legislative changes that tightened disability requirements for federal employees, substituted annual adjustments for semiannual increases in CSR benefits, and prorated the initial adjustments received by new annuitants to reflect more accurately price increases since individual retirement dates. The growth in compensation costs was also checked by reductions in the number of federal civil servants. (In the 1980-1982 period, a cutback of some 168,000 Executive Branch jobs was offset by Defense Department hiring of some 49,000 more civilians.) Without these moderating factors, some $6 billion would have been added to federal payroll costs in 1982 and about $1 billion (on an annualized basis) to payments for federal pensions.

The Current Situation

For 1983, the Congress has cut compensation outlays by some $2.0 billion by reducing various features. About 92 percent of that savings derived from the decision to continue the past practice of restraining the size of annual federal pay raises. The Congress halved the 8 percent annual pay adjustment (CBO's estimated annual rise in private-sector pay as incorporated in the baseline developed last year for 1983) to 4 percent for most government workers. By comparison, the Office of Personnel Management estimated that an average adjustment of 18.5 percent (ranging from 15 to 31 percent) would have been required in 1983 to make federal white-collar salaries comparable with those currently paid for similar private-sector work. (In a related action, the Office of Management and Budget required federal agencies to absorb about half of the costs resulting from both the 4

TABLE VIII-1. BUDGETARY OUTLAYS AND RECEIPTS FOR FEDERAL CIVILIAN COMPENSATION (In billions of dollars)

Major Program	Actual 1980	Actual 1982	Estimated 1983	Baseline Projection 1984	1985	1986	1987	1988
				Gross Outlays				
Pay	44.4	51.0	53.2	56.1	59.0	61.9	64.9	68.1
Civil Service Retirement	14.7	19.5	21.2	22.8	24.4	26.4	28.3	30.2
Other Benefits a/	4.9	6.6	8.3	10.1	12.1	14.3	17.0	20.2
Total	64.0	77.1	82.7	89.0	95.5	102.6	110.2	118.5
				Receipts and Collections				
Civil Service Retirement	5.2	5.8	6.0	6.2	7.0	7.5	7.7	8.0
Other Benefits a/	2.4	3.6	4.4	5.4	6.4	7.6	9.0	10.7
Total Offsets b/	7.6	9.4	10.4	11.6	13.4	15.1	16.7	18.7
				Net Budget Impact				
Total	56.4	67.7	72.3	77.4	82.1	87.5	93.5	99.8

a. Includes group health plans, life insurance, and workers' compensation.

b. Includes contributions from federal employees and off-budget agencies, which represent federal revenues and offsetting receipts, respectively.

percent pay adjustment and the imposition of the 1.3 percent Medicare tax that began January 1983. These absorption requirements may cause a slowdown in hiring of new employees and cuts in nonpay items such as travel.)

The remaining 8 percent of 1983 compensation savings, totaling $0.15 billion, resulted from numerous measures contained in the Reconciliation Act of 1982. Under that act, the Congress temporarily reduced three features of compensation: the pay of military retirees employed by the government as civilians (so-called "double dippers"), the frequency of cost-

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of-living adjustments (COLAs) for all federal retirees, and the size of COLAs received by retirees under age 62. 1/ These reductions are to be effective through 1985. The act also specifies permanent changes that modify restrictions on counting post-1956 military service toward federal civilian retirement benefits, and required administrative changes in the calculation or timing of certain pay and benefits received. These changes are projected to have relatively small effects in 1983, but taken together, they help control costs in future years.

Baseline Projections, 1984-1988

During the 1984-1988 period, combined federal outlays for civilian pay and benefits are projected to grow from $89 billion to $118 billion. This represents an average annual increase of 5 percent in payroll costs, and 11 percent in benefit costs. (The CBO assumes annual inflation rates over the same period to average about 4 percent.)

The five-year projections for federal civilian payroll costs assume no further employment reductions in the nondefense agencies beyond those already scheduled through 1983. They do, however, reflect the 3 percent growth in Defense Department civilian employment projected by the Administration for the 1984-1988 period. In addition, annual pay raises included in the CBO baseline assume that federal wages rise at the same rate as those going to comparable private-sector employees. Those rates exceed--by about 1.1 percentage points per year--the 4 percent pay increases targeted for 1984 and 1985 by the 1983 budget resolution, and exclude the 14 percent

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1. The Reconciliation Act of 1982 lengthens the interval between COLAs to 13 months for 1983, 1984, and 1985. During this time, civil service retirees younger than age 62 will also receive smaller increases than older CSR annuitants, unless the annual rate of inflation (as measured by the CPI) falls below 3.6 percent. The COLAs for younger CSR retirees are guaranteed at least to equal 3.3 percent, 3.6 percent, and 3.3 percent, respectively, through 1985, but not to exceed the annual change in the CPI less the rate guaranteed for each period. Other changes required by the 1982 act in administering federal compensation include increasing the number of scheduled work hours per year (from 2,080 to 2,087) used to calculate salaries for most white-collar federal employees, rounding down retirement benefits to the nearest lower dollar, eliminating pension payments for partial months attributable to date of retirement, and tightening eligibility provisions for disability and early retirement.

"catch-up" to close the gap between federal and private-sector pay that has resulted from prior-year limits. 2/

Higher federal benefit costs result mainly from outlay increases in two areas--Civil Service Retirement and health insurance (the Federal Employees Health Benefit, or FEHB, program). 3/ Together, these programs are projected to grow from $31 billion to $47 billion--a 53 percent increase--with about five-ninths of the growth resulting from higher health-care costs. Expiration of temporary measures enacted to limit COLAs for federal retirees is also reflected in CBO projections.

DEFICIT REDUCTION STRATEGIES

Two fundamental paths are available to the Congress for limiting federal compensation costs: to lower the number of recipients of federally funded pay and employment benefits, and to restrict the size of such payments. One obvious way to curb the projected growth in federal compensation costs would be to freeze civilian pay and benefits at 1983 levels. A one-year moratorium on annual civilian pay increases and pension adjustments, for example, would reduce 1984 outlays by some $2.9 billion. Less severe options that also affect federal compensation levels range from adopting practices more typical of private-sector employers to enacting narrowly targeted federal pay and benefit modifications.

In addition, the Congress could also increase the government's reliance on the private sector for providing services of a commercial nature. 4/ This chapter identifies the potential budgetary effects of accelerating the government's use of certain contractor-provided services. It also examines one aspect of recovering costs by charging users of federally supplied

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2. In light of past practices for restraining federal pay increases, it does not appear realistic for baseline projections to assume implementation of pay comparability, as currently measured by the Office of Personnel Management under the Pay Comparability Act of 1970. The Office of Personnel Management believes the pay comparison process needs reform and could submit new proposals this year.

3. For further analysis of these programs, see Congressional Budget Office, Civil Service Retirement: Financing and Costs (May 1981) and Reducing the Reserves of the Federal Employees Health Benefit Program (June 1981).

4. For further analysis, see Congressional Budget Office, Contracting Out for Federal Support Services: Potential Savings and Budgetary Savings (October 1982).

services--namely, by eliminating certain indirect cost subsidies enjoyed by customers of the U.S. Postal Service. (Chapter IX examines numerous other applications of the user-charge principle.)

REDUCING FEDERAL PAY

If the main objective of 1984 budget strategies is to achieve immediate savings that will increase over time, several pay reduction possibilities are available. The courses identified in this section entail no reduction in the level of federal programs or services, although decreases in service quality might eventually result. Adoption of any of the alternatives would avoid substantial budgetary costs over the next five years--outlay savings estimated to range between $6 billion and $20 billion (see Table VIII-2). The approaches described in this section can be viewed as practical--albeit austere--public policy responses to persistent requirements for federal budgetary constraint. All would set aside the legislative goal of making federal pay comparable with that in the private sector, however, because achieving salary comparability, as it is measured under current law, would be so costly.

Opponents of such measures would argue that the proposals have little in common with compensation practices considered typical of the nonfederal sector and, if adopted, would undermine the role of the government as a model employer. They would claim that recently enacted limits on the size of annual pay increases, as well as on the timing and amount of post-retirement COLAs, should more than satisfy the government's need to reduce federal compensation costs.

Delay Within-Grade Pay Increases

Most blue-collar and white-collar federal employees (except managers and supervisors) are eligible for periodic pay increases based essentially on length of service. The waiting period for these so-called "within-grade" increases ranges from a minimum of one year to a maximum of three years, depending on time served in a position at a particular grade. 5/ If the

5. The majority of federal white-collar employees are covered by Grades 1 through 15 of the General Schedule, which consists of 10 steps per grade. The statutory pay system for most blue-collar employees, the Federal Wage System, consists of 15 grades with 5 steps each. Longevity step increases only affect pay rates, and do not imply changes in an individual's job responsibilities.

TABLE VIII-2. BUDGET SAVINGS FROM STRATEGIES TO REDUCE PAY AND PENSIONS FOR FEDERAL CIVILIAN EMPLOYEES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Delay Within-Grade Pay Increases						
Budget Authority	0.3	0.6	1.1	1.8	2.5	6.3
Outlays	0.3	0.6	1.1	1.8	2.5	6.3
Index Pay to CPI Changes						
Budget Authority	0.7	0.9	1.1	1.5	2.1	6.2
Outlays	0.7	0.9	1.1	1.5	2.1	6.3
Freeze 1984 Pay and Pension Adjustments						
Budget Authority	2.6	3.4	3.6	3.6	3.8	17.1
Outlays	2.9	4.0	4.2	4.4	4.6	20.0
Modify CSR Benefits						
Budget Authority	--	0.2	0.4	0.5	0.7	1.7
Outlays	0.2	0.6	1.2	1.7	2.3	5.9
Revamp CSR System						
Budget Authority	-0.1	-0.3	-0.5	-0.7	-0.9	-2.5
Outlays	--	0.1	0.2	0.3	0.3	0.9
Adjust Certain CSR Annuities for Past Overcompensation						
Budget Authority	--	0.1	0.2	0.3	0.4	1.0
Outlays	0.1	0.2	0.5	0.8	1.0	2.6

NOTE: Totals may not add because of rounding.

waiting periods were extended for all employees by six months, five-year savings would total $6.3 billion.

Prolonging the intervals between within-grade pay raises is a plausible and less disruptive alternative to civilian employment reductions, which have been carried out in many federal agencies. Further, it might offer an incentive for federal workers to improve performance so as to increase eligibility for pay increases gained through promotions or cash awards. The opposite view is that any change in the rules governing within-grade raises would violate the terms of federal employment and would depress employee morale. Because of the effective reduction in wages, the federal service theoretically would attract and retain less qualified personnel, though analytically measuring the effects of such changes would be difficult.

Index Pay Adjustments to CPI Changes

Under current policy, the annual October pay adjustments recommended for federal white-collar employees are designed to keep federal salaries equivalent to those paid in the private sector for similar work. Since 1970, however, six adjustments below comparability have been approved under current provisions of law, and the Congress recently established a budgetary target whereby annual pay increases would not exceed 4.0 percent through 1985. If, for the next five years, the Congress set aside the pay comparability authorization by tying government-wide adjustments to changes in inflation (as measured by the CPI) only, annual pay raises would average 4.3 percent--about 0.7 percentage points below the average change in private-sector rates.

Tying federal civilian pay adjustments to the annual change in the CPI would provide an interim rationale for determining their size and give the Congress time to evaluate other pay reform approaches. Relative to the CBO baseline, CPI indexation could save $6.3 billion over the 1984-1988 projection period. (The CBO baseline assumes annual federal pay increases to equate to adjustments projected through 1988 for nonfederal workers.) Moreover, when combined with within-grade increases and promotions for career advancement, the pay of many federal workers would exceed CPI increases and thus grow in purchasing power.

Long-term use of such indexation in place of the pay comparability standard, which looks to private-sector salary levels as the norm, could be viewed by many critics as a significant dilution of the equal-pay-for-equal-work doctrine. Such action could ultimately lead to recruitment and retention problems that adversely affect the delivery of federal services. Continued federal layoffs and high national unemployment, however, would probably limit or delay such effects.

Freeze 1984 Pay and Retirement Adjustments

Current law provides for annual adjustments both in federal employees' pay and in CSR annuities. Together, these adjustments account for most of the last decade's growth in federal compensation costs. For civilian white-collar employees, pay adjustments occur each October on a nationwide basis; for blue-collar workers, annual adjustments occur at different times of the year on a local area basis. Cost-of-living adjustments for CSR annuitants are generally granted each March, although the 1982 Reconciliation Act delays adjustments by one, two, and three months, respectively, for each of the next three years. If, in 1984, a government-wide freeze on civilian pay and retirement adjustments were enacted for one year, savings through 1988 would accumulate to $20 billion--$16 billion from pay and $4 billion from retirement.

Advocates of these measures would point not only to potential budgetary saving, but also to examples in earlier periods and the private sector. Skipping the 1984 adjustments both in active-service pay and in annuities would follow precedents set in the 1950s and early 1960s. During that period, pay and post-retirement increases were provided on an irregular, ad hoc schedule--on average, once every 24 months. Moreover, because of economic conditions, pay freezes have recently become a subject in an increasing number of private-sector labor negotiations, and they may be considered by several state governments as well. 6/

Critics would view the wage-freeze proposal as unfair, because it would apply only to a small segment of the nation's labor force--one whose liberal and nontransferable retirement benefits, in particular, discourage job mobility. Opponents of a freeze would also point out that federal pay adjustments have failed to keep pace not only with the cost of living (as measured by the CPI), but also with compensation practices in the private sector--in theory, at least, the benchmark against which federal compensation is measured. (To counter this argument, of course, observers might note that private-sector pay, too, has lagged behind the cost of living, and that unemployment in the private sector stands at a record high level.) In addition, a pay freeze could prompt experienced federal employees and top managers to retire early (a practice that itself has federal costs) and possibly create recruitment and retention problems.

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6. It is difficult to determine the net reduction that selective pay freezes would have on the overall increase in private-sector salaries. To the extent that reductions occurred, potential savings from a federal wage freeze, relative to the CBO baseline, would decline.

REDUCING FEDERAL PENSION COSTS

Federal employees contribute more toward their retirement program than do their private-sector counterparts who are covered not only by an employer-provided annuity plan but also by Social Security. A portion of private-sector retirement income--mainly, the Social Security share--is now tax-free, whereas CRS pensions are fully taxed after a retiree's benefit payments exceed the contributions he made during his career as an active worker. Even taking into account differences in contributions (private-sector workers rarely contribute to their pension plans) and tax status, however, CSR annuitants still receive more generous benefits. 7/ From this point of view, the government's retirement costs are higher than the typical private-sector employer's.

The level of an annuitant's CSR benefit is based on his years of federal service and on the three years of his highest earnings. In light of the relationship between salary levels and annuities, and the fact that pay and benefit cuts enacted since 1980 are unlikely to be reversed, large reductions in prospective federal pension costs will require more fundamental policy decisions. Some of these decisions have been postponed because of modest short-term effects or because equivalent budgetary savings could be achieved through less complicated or far-reaching measures.

Better alignment of federal retirement costs with private-sector retirement could be achieved by changing the CSR program either in conjunction with extending Social Security coverage to federal employees (addressed in Chapter III), or by applying an independent measure that would establish CSR as a substitute for the two-part retirement income generally available in the private sector. Two of the options described below follow this latter strategy. One would modify selected benefit provisions; the other would completely reconstruct the system. (Of course, the net budgetary impact of federal retirement costs could also be reduced by increasing employee or off-budget agency contributions. However, increasing employees' payroll withholdings--these are generally set at 7 percent of pay and matched by employing-agency contributions--would not align the federal system with the private sector, in which employee contributions are generally limited to Social Security withholding taxes plus a portion of premium costs for long-term disability insurance. Increasing contributions

7. If the tax advantage now available to Social Security annuitants were reduced--by the enacting of either the recent recommendations of the National Commission on Social Security Reform or a similar proposal--the relative advantages of CSR benefits would rise accordingly.

from off-budget agencies is described later in this chapter.) The last strategy, reducing future COLAs for certain CSR recipients, would adjust federal pensions for what is held to be past "overcompensation." All the alternative strategies would depart from recent federal policy, which kept retirement costs relatively high while limiting the size of annual active-service pay adjustments.

Modify Civil Service Retirement Benefits

Compared with retirement payments typical of the two-part system available to private-sector workers, benefits under CSR are large. If the Congress patterned CSR benefit provisions after typical private-sector practice, federal costs would decline. Such a modified CSR benefit structure could include the following actions:

- Gradually reduce earned benefits for federal workers who retire before age 65, regardless of their length of service. At present, CSR benefits are available without reduction either at age 55 after 30 years of service or at age 60 after 20 years of service. The 1988 savings would be $0.1 billion.

- Calculate benefits based on the employee's average salary for the five years of highest earnings--rather than the three-year average currently used. The 1988 savings would be $0.3 billion.

- Base annuity reductions for survivor benefits on actuarial factors, which would vary by the age of the retiree and of the spouse. Under the present system, reductions equal a fixed percentage of the earned annuity regardless of age differentials. The 1988 savings would be $0.2 billion.

- Limit COLAs to 33 percent of changes in the CPI for retirees under age 62 and to 70 percent for those aged 62 and older. This would achieve a blend of average adjustments provided by Social Security, which is indexed to the full amount of the change in the CPI, and the ad hoc increases available under some private pension plans. The 1988 savings would be $1.6 billion.

Except for limiting COLAs, these modifications in CSR benefits would apply to new retirees only and thus would yield relatively small savings in the first five years. In the long run, however, savings from non-COLA changes would grow, as more and more individuals joined the retirement rolls. In the area of COLAs, the changes would apply to new and current annuitants alike, and thus they would generate savings in the near term--beginning at $0.1 billion in 1984 and reaching $1.6 billion in 1988. A less severe limit could be considered by simply extending--beyond 1985--a measure similar to the temporary COLA limit now in effect on the amounts received by younger retirees. But if future adjustments for CSR retirees younger than age 62 were set at 70 percent of the CPI, for example, outlay savings in 1988 would barely reach $0.1 billion.

Support for modifying CSR benefits would rest on the belief that federal costs, which are ultimately paid by the taxpayer, should hold to the standard that would prevail if the government adopted practices more typical of the private sector. The contrary view holds that existing CSR benefits are fair recompense for pay limits effective during active federal employment, and that employees--especially those near retirement--would be unfairly hurt by unanticipated changes in the rules determining their pension benefits. This latter objection could be met by a gradual phase-in of the changes.

Revamp Civil Service Retirement

As an alternative to modifying particular benefit provisions, the Congress could establish individual retirement accounts for new employees. Under current practice, agency and employee contributions are pooled, and together, they partially fund the annuities of former employees who have already retired and whose benefits greatly exceed amounts contributed on their behalf. Funds for the remaining benefit costs require annual appropriations from the U.S. Treasury. Instead, projected benefit payments could be prevented from exceeding amounts contributed by employees and agencies into the individual earmarked accounts, as augmented by interest earnings.

Many different fixed-rate plans are possible, varying according to provisions covering contribution levels, investment of funds, participation of current employees, and circumstances under which benefits can be drawn. 8/ A fixed-rate plan could be financed in the following manner.

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8. The fixed-rate plan described here differs from that contained in S. 2905, introduced in the Senate in September 1982. If enacted, that bill would also provide Social Security coverage, an optional thrift plan, and a fixed-rate plan for new federal workers. In addition, the bill would eventually allow investments in financial instruments other than U.S. Treasury securities, which would cause federal outlays to rise and could require significant resources to administer. Finally, S. 2905 would also allow participation by current employees.

Employee contributions could remain at the current withholding rate of 7 percent of pay; employing agency contributions would be raised to 21.5 percent, at which level they would equate to the combined actuarial value of Social Security (less projected employee contributions) plus a typical employer-provided pension plan. Total contributions would thus come to 28.5 percent. The value of such benefits would roughly equal four-fifths of those now available, largely because of the loss of guaranteed COLAs. (Such adjustments are expensive under any economic conditions. But because of the double-digit inflation rates recently experienced--double or triple the long-term projections actuaries use--the cost impact of COLAs has been particularly dramatic.)

Under a fixed-rate plan, the true cost of federal pensions would equal agency contributions and, as the annual appropriations necessary to fund current benefits gradually disappeared, long-term savings would begin to result. In the near term, however, neither appropriations nor outlays for CSR benefit payments would be appreciably affected, because the plan would apply to new employees only. But higher contributions from off-budget agencies, primarily the Postal Service, would result in outlay reductions of $0.9 billion through 1988. Finally, given growing concern over near-term outlay increases, the plan could avoid budgetary expenditures by limiting its investments to special U.S. Treasury issues (securities), and by making the government's contribution available in full only to workers who stay in the system for a specified term--for example, five or ten years.

If the Congress were to extend Social Security coverage to new federal employees (as described in Chapter III), the government's cost for the portion of benefits from a fixed-rate plan could drop from the 21.5 percent rate cited above to 8.4 percent of salary. This rate reduction would be made up by the federal costs for Social Security, including those associated with the system's current underfunding and the tax-free status of its benefits. Advocates of this plan would find several advantages in it, including the transferability of benefits between public- and private-sector employment, the elimination of the "windfall" payments now available to federal retirees after relatively few years of Social Security participation, and, of course, the curbed federal pension costs.

At present, most employees who leave government service before retirement age elect to withdraw their contributions rather than receive the deferred annuity to which they are entitled upon turning 62. A fixed-rate pension plan would allow intermittent and short-term federal employees the opportunity to accrue continued investment earnings on their contributions--either to take advantage of the tax-deferred feature of the plan's dividends, or in anticipation of eventually securing entitlement to the government's contribution and associated investment earnings. As a result, the percentage of workers who eventually receive a federal annuity would increase. On the other hand, benefits for career employees would drop substantially because the government's costs (employer contributions and Treasury appropriations) would decline as a percent of payroll, while the number of recipients would increase. In addition, major administrative hurdles would undoubtedly arise in implementing a fixed-rate plan.

Adjust Certain CSR Annuities for Past Overcompensation

Statutory provisions governing COLAs under CSR during the 1970-1976 period caused each adjustment to reflect the full change in the CPI plus one additional percentage point. Although the Congress withdrew the add-on in 1976, it did not make the rescission retroactive. Thus, the add-on continues to affect the size of current benefits of pre-1977 retirees and has led to what some observers consider overcompensation. Another type of overcompensation has also resulted, especially in recent years, because retirement COLAs have often exceeded annual pay adjustments. In combination, these factors have caused the retirement pay of many federal annuitants who retired between 1970 and 1976 to be higher than that of workers who retire today at similar grade levels and with comparable periods of government service. This overcompensation could be corrected by temporarily restricting future COLAs for affected CSR annuitants to half the CPI change. The duration of the restriction would depend upon the difference between the COLAs received and the size of federal pay raises since the individual's date of retirement. Such action would yield annual savings totaling $1.0 billion in 1988.

Proponents of a COLA limit would argue that cuts affecting retirees who benefited from the pre-1977 overindexation would be appropriate--especially in times of budgetary stringency--and fair. They would also note that the CPI has overstated rises in the cost of living, especially in recent years, and benefit increases linked to that indicator have tended to be excessive. The flaw in the CPI, pertaining to the weight given to shelter costs, has been corrected prospectively--by a change to be effective in 1985; adjustments to correct retroactively for past overindexation have not been proposed. In addition, civil service retirees have enjoyed greater protection against price increases than have their private-sector counterparts and federal employees, whose pay raises have lagged behind the CPI. If this greater protection continues, federal workers--particularly during periods of high inflation--would have stronger incentives to retire as soon as they become eligible, leading to upward pressure on federal retirement costs.